

Before the
Federal Communications Commission
Washington, D.C. 20554

DOCKET FILE COPY ORIGINAL

In the Matter of)

)
Prescribing the Authorized Unitary Rate of)
Return For Interstate Services of Local)
Exchange Carriers)

CC Docket No. 98-166

RECEIVED

MAR 16 1999

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

**RESPOSIVE SUBMISSION AND REPLY COMMENTS OF
SBC COMMUNICATIONS, INC.**

SBC Communications Inc. (SBC), on behalf of Southwestern Bell Telephone Company (SWBT), Pacific Bell (Pacific), and Nevada Bell (Nevada), (collectively, the SBC Companies), and pursuant to the Notice Initiating A Prescription Proceeding And Notice Of Proposed Rulemaking (Notice) released October 5, 1998¹ by the Federal Communications Commission (Commission), hereby submits its Responsive Submission and Reply Comments in the above styled matter. In this pleading, SBC responds to the comments of New Network Institute (NNI), MCI WorldCom, Inc. (MCI), General Services Administration (GSA) (as well as the Direct Case of GSA), and AT&T Corp. (AT&T). None of these comments or pleadings provide any basis to reduce the authorized rate of return, nor to reset the low-end adjustment formula in the price cap mechanism.

I. THE AUTHORIZED RATE OF RETURN SHOULD BE INCREASED

As indicated in the comments filed on behalf of USTA by Drs. Avera and Billingsley, the comments submitted by GSA, AT&T, MCI and others do not provide substantial evidence that a represcription should go forward or, if it did, that the authorized rate of return should be lowered. In fact, the evidence of Drs. Avera and Billingsley strongly demonstrates that if a represcription should occur, it should appropriately find that the previously authorized rate of return of 11.25% is simply too low.

¹ Prescribing the Authorized Unitary Rate of Return for Interstate Services of Local Exchange Carriers, CC Docket No. 98-166, Notice Initiating A Prescription Proceeding And Notice of Proposed Rulemaking, (FCC 98-222) (rel. October 5, 1998). (Notice)

No. of Copies rec'd 014
List A B C D E

GSA, NNI, MCI, and AT&T ignore the increasing risks of providing access services as a result of competition, technological advances and regulatory uncertainty. As a result, evidence from the capital markets implies that the cost of capital for ILECs has very likely risen, not fallen, as incorrectly opined by these parties. The combination of higher risks increases the cost of equity for the ILECs and the requisite shift in capital structures toward much higher equity levels has resulted in a higher cost of capital.

If, indeed, a represcription were determined to be in the best interests of telecommunications providers and users of telecommunications services, the comments of Prof. Billingsley show that the cost of capital has indeed increased since the last represcription. Not only has the cost of equity gone up more than enough to offset declining debt costs, but the requisite increase in the equity ratio to compensate for increased risk leads to a significantly higher cost of capital for ILECs. This is completely contrary to the comments filed by GSA, NNI, MCI and AT&T.

Thus, not only is there no basis to reduce the authorized rate of return, but if any action is taken at all, the authorized rate of return should be increased. For these reasons, SBC fully supports the reply of USTA.

II. CLAIMS THAT LECS' EARNINGS ARE EXCESSIVE INACCURATELY PORTRAY LEC RATES OF RETURN.

MCI asserts that the price cap LECs as a group have earned above the current unitary rate of return of 11.25% as reasoning for eliminating or reducing the low-end adjustment formula. AT&T makes a similar allegation.²

On the contrary, the SBC Companies have not experienced above average earnings levels. In the case of SWBT in 1997 the reported interstate ROR on the 492 report was 10.32%, barely above the benchmark for the low-end adjustment. In the case of Pacific Bell, it was a little higher at 11.90%.

² MCI at p. 5; AT&T at pp. 5-6.

Furthermore, those reported returns are predicated on Commission Part 32 accounting procedures which tend to significantly overstate reported results. Part 32 does not closely embody Generally Accepted Accounting Principles (GAAP) and thus earnings of LECs frequently are not calculated on a basis consistent with outside nonregulated firms. Any conclusions concerning the earnings of LECs are irrelevant here, but if cited at all, those results must be restated based upon GAAP.

A case in point is the determination of depreciation expense. LECs are constrained to book depreciation based on rates which fall within preapproved industry ranges or guidelines determined by the Commission for each plant category. Prior to 1995, the depreciation rates were simply determined in a 3-way meeting process involving the ILEC, Commission staff, and each State Commission Staff.

The depreciation rates determined from the above process have not in the past provided for adequate capital recovery of plant. As a consequence, when the Bell Operating Companies departed from reporting financial results on Commission ordered and prescribed accounting methods (Statement of Financial Accounting Standards No. 101) in the mid 90's, it was necessary for these companies to book huge adjustments to the depreciation reserves to reflect this fact.

In the case of SWBT, a pre-tax write off of \$4.6 billion was booked in the 3rd quarter of 1995, most of which consisted of a restatement of accumulated depreciation. Pacific booked \$5.7 billion in the same quarter. As of the end of 1997 (as filed in the Arthur Andersen Report in CC Docket No. 98-81, attachment 4, filed on November 10, 1998) SWBT still had unrecovered plant of \$4.1 billion and Pacific had \$4.2 billion.

Were SWBT and Pacific to embark upon a lengthy recovery program of 10 years to recognize and "catch-up" the additional depreciation expense and had done so starting in 1997, this would have radically impacted the reported return of both companies for 1997 as follows: SWBT's revised return would be 8.47%, and Pacific's revised return would be 9.64%.

Depreciation is the largest single factor separating GAAP from Commission prescribed accounting procedures. Other items such as an expense limit for network plant could additionally serve to reduce the rate of return. Therefore, references to windfall profits are irrelevant and inaccurate and should not provide any basis to change the LFAM.

III. THE LOW END ADJUSTMENT MECHANISM SHOULD NOT BE ELIMINATED WITHOUT APPROPRIATE MODIFICATIONS TO THE REMAINING ELEMENTS OF THE PRICE CAP FORMULA.

MCI claims that the lower formula adjustment mechanism is no longer necessary and should be eliminated.³ MCI argues that since adopting its original price cap plan, the Commission has eliminated upside sharing, so that price cap LECs can now in principle keep any level of earnings they achieve. MCI concludes that if the Commission still wishes the LECs to face the same downside risk as upside opportunity the lower formula adjustment should be completely eliminated. AT&T claims that the lower formula adjustment should be eliminated, asserting that the Commission's order eliminating sharing, but retaining the LFAM, was "lopsided," "anomalous," and "ironic."⁴

As SBC has noted, there are reasons for eliminating the LFAM within the context of other regulatory changes. When these other changes to price cap LEC regulation are made (e.g. adequate pricing flexibility), it would be equitable to remove the limited protection against confiscatory rates that the LFAM provides. Now, however, the limited protection afforded by the LFAM is far outweighed by the risks inherent to ILECs in the rest of price cap regulation. This complex balancing act is not made more equitable by increasing the risks to ILECs by eliminating the LFAM.

Indeed, although AT&T attempts to paint itself as a fierce advocate of eliminating the LFAM, its recent briefing in the appeal of the 1997 Price Cap Order belies this posturing and acknowledges the relationships between LFAM and other aspects of the price cap formula. In its brief defending the Commission's order, AT&T stated that: "there is no sound basis to set aside

³ MCI at p. 4.

⁴ AT&T at pp. 3-5.

the Order simply because the LEC petitioners may disagree with the results and advance...criticisms of the Commission's methodology.⁵ One of those criticisms "advanced" by the LECs was the Commission's retention of a CPD in the price cap formula. AT&T passionately defended this part of the new formula: "[I]t was entirely reasonable for the Commission to look out for the interests of access customers under its newly adopted no-sharing policy by incorporating the CPD in the X-factor calculation."⁶ Thus, AT&T apparently agreed with the Commission's decision to trade a "no-sharing" policy for CPD retention. Now, however, AT&T changes its tune and claims that more of a trade is needed. This claim is inconsistent and if AT&T had thought the trade-off was unfair, it should have made that position clear on appeal. It should not state that the Commission has been "thorough and convincing"⁷ on the one hand, and argue that the same order is now somehow "lopsided," anomalous", and "ironic" on the other.

⁵ AT&T brief at p. 5.

⁶ AT&T brief at p. 18 (emphasis added).

⁷ AT&T brief at p. 19.

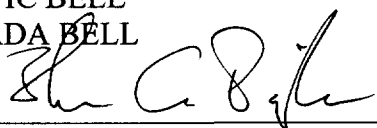
IV. CONCLUSION

For the foregoing reasons, the Commission should not change the authorized rate of return and should not make any changes to the LFAM (unless other appropriate regulatory changes are simultaneously made.)

Respectfully submitted.

SBC COMMUNICATIONS INC.
SOUTHWESTERN BELL TELEPHONE COMPANY
PACIFIC BELL
NEVADA BELL

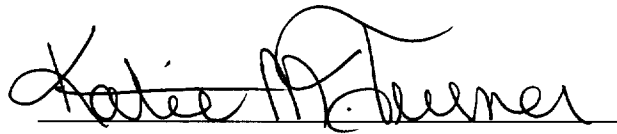
By: _____


Robert M. Lynch
Roger K. Toppins
Michael J. Zpevak
Thomas A. Pajda
One Bell Plaza, Room 3003
Dallas, Texas 75202
214-464-5307
Their Attorneys

March 16, 1999

CERTIFICATE OF SERVICE

I, Katie M. Turner, hereby certify that the foregoing, "RESPONSIVE
SUBMISSION AND REPLY COMMENTS OF SBC COMMUNICATIONS, INC." in
CC Docket No. 98-166 has been filed this 16th day of March, 1999 to the Parties of
Record.

A handwritten signature in black ink, reading "Katie M. Turner", written over a horizontal line.

Katie M. Turner

March 16, 1999

SECRETARY
FEDERAL COMMUNICATIONS COMMISSION
THE PORTALS
445 TWELFTH STREET, S.W.
WASHINGTON DC 20554

ITS
1231 20TH STREET, N.W.,
WASHINGTON DC 20036

JUDY SELLO
MARK C. ROSENBLUM
AT&T CORP.
ROOM 324511
295 NORTH MAPLE AVENUE
BASKING RIDGE, NJ 07920

CHRIS FRENTROP
SENIOR ECONOMIST
MCI WORLDCOM, INC.
1801 PENNSYLVANIA AVENUE NW
WASHINGTON DC 20006

BRUCE A KUSHNICK
EXECUTIVE DIRECTOR
NEW NETWORKS INSTITUTE
826 BROADWAY
SUITE 900
NEW YORK NY 10003

GEORGE N BARCLAY
MICHAEL J ETTNER
GENERAL SERVICES ADMINISTRATION
1800 F STREET NW
ROOM 4002
WASHINGTON DC 20405

JAMES T HANNON
U S WEST COMMUNICATIONS INC
SUITE 700
1020 19TH STREET NW
WASHINGTON DC 20036

JOHN F RAPOSA
GTE SERVICE CORPORATION
600 HIDDEN RIDGE, HQE03J27
P O BOX 152092
IRVING TX 75015-2092

GAIL L POLIVY
GTE SERVICE CORPORATION
1850 M STREET NW
WASHINGTON DC 20036

EDWARD D YOUNG, III
MICHAEL E GLOVER
BELL ATLANTIC TELEPHONE COMPANIES
1320 NORTH COURT HOUSE ROAD
EIGHTH FLOOR
ARLINGTON VA 22201

KATHRYN A ZACHEM
J WADE LINDSAY
WILKINSON, BARKER, KNAUER & QUINN, LLP
U S WEST, INC.
2300 N STREET NW
WASHINGTON DC 20037

UNITED STATES TELEPHONE ASSOCIATION
1401 H STREET NW
SUITE 600
WASHINGTON DC 20005

CHRISTOPHER J WILSON
STAFF COUNSEL
CINCINNATI BELL TELEPHONE COMPANY
201 EAST FOURTH STREET
SUITE 102-620
CINCINNATI OH 45201

GREGORY J VOGT
BRYAN N TRAMONT
WILEY, REIN & FIELDING
VIRGIN ISLANDS TELEPHONE CORPORATION
1776 K STREET NW
WASHINGTON DC 20006